



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Discussion Paper | DP1/14

# Ensuring operational continuity in resolution

October 2014

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## 1 Overview

1.1 This discussion paper (DP) sets out the Prudential Regulation Authority's (PRA's) preliminary views on the principles that firms' operational arrangements must satisfy in order to facilitate recovery actions, resolution, and post-resolution restructuring.

1.2 Feedback received to this DP will be used to ensure that any draft rules that the PRA consults on in the future will be as effective as possible, while at the same time minimising any unintended consequences. Following the end of the discussion period on this DP, and as the Financial Stability Board's (FSB's) work in this area evolves, a subsequent consultation paper with draft rules may be published in 2015.

1.3 The proposals relate to the PRA's Fundamental Rule 8 which stipulates that *'A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services'*.

1.4 The PRA welcomes comments from interested parties on all aspects of this paper and the specific questions listed at the end by Tuesday 6 January 2015.

### Context

1.5 This DP is one of four papers published by the PRA on 6 October as part of its wider resolution and resilience agenda. The proposed rules and policies on which the PRA is seeking feedback contribute to this agenda in a number of ways. Enhanced protection for depositors and insurance policyholders and better access to protected deposits in the event of the failure of a firm will reduce disruption to the economy (see CP20/14 and CP21/14).<sup>(1)(2)</sup>

1.6 The proposals set out in this DP cover operational continuity in resolution for banks, building societies and investment firms regulated by the PRA. The proposals are aimed at ensuring that firms of all sizes make the appropriate changes so that services necessary for the continuity of deposit-taking and other functions critical to the economy operate effectively following the failure of a firm.

1.7 The PRA is also consulting on its first package of proposals to implement the ring-fencing of core UK financial services and activities, as required under the Financial Services and Markets Act 2000 (the 'Act') as amended by the Financial Services (Banking Reform) Act 2013 (see PRA CP19/14).<sup>(3)</sup> For banking groups subject to ring-fencing, the Act requires the PRA to ensure the effective provision to a ring-fenced body (RFB) of the services and facilities it requires to carry on a 'core activity' (as defined in the Act). Any eventual rules based on the approach discussed in this DP would help meet the PRA's rule-making responsibilities under the Act in respect of RFBs.

1.8 These measures advance the PRA's general objective of promoting the safety and soundness of firms by reducing the adverse effect that the failure of firms could be expected to have on the stability of the UK financial system. Proposals to enhance insurance compensation advance the PRA's objective of contributing to the securing of an appropriate degree of protection for those who are, or may become, policyholders.

### Scope of the proposals

1.9 This DP should be read by all PRA-authorised banks, building societies and investment firms to which any eventual proposals may apply. The paper is also likely to be of interest to policymakers and practitioners involved in the resolution of failed firms, as well as insurance firms for which similar proposals may be extended after a separate consultation at a later stage.

1.10 Any eventual proposals would be applied on a proportionate basis and the extent to which a firm would have to restructure its operational arrangements will depend on:

- the extent to which its failure would impact the UK financial system;
- whether it has critical economic functions;
- the resolution strategies that may be applied to the firm; and
- whether any barriers to executing those potential resolution strategies are identified.

1.11 The PRA expects that only those firms that have been asked to submit 'Phase Two' information under SS19/13<sup>(4)</sup> would need potentially to undertake material actions to ensure that their arrangements satisfy the principles set out in this DP.

1.12 With respect to deposit-takers, CP20/14 on depositor protection proposes requirements that will allow continuation of deposit accounts when a firm fails, including processing and settling incoming and outgoing payments. For some firms, the PRA considers that, to the extent that firms are in compliance with the requirements resulting from that CP, any actions necessary to achieve the outcomes set out in this DP should

(1) PRA Consultation Paper CP20/14, 'Depositor protection', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2014.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2014.aspx).

(2) PRA Consultation Paper CP21/14, 'Policyholder protection', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2114.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2114.aspx).

(3) PRA Consultation Paper CP19/14, 'The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp1914.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp1914.aspx).

(4) PRA Supervisory Statement SS19/13, 'Resolution planning', December 2013; [www.bankofengland.co.uk/pr/Documents/publications/ss/2013/ss1913.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/ss/2013/ss1913.pdf). 'Phase Two' information refers to additional information that firms may be asked to submit to support the authorities' preferred resolution strategy in cases where this resolution strategy has to ensure the continuity of critical economic functions.

be minimal. These are likely to be firms whose critical economic functions are limited to deposit-taking and/or who are small deposit-takers. This may also depend on the expected resolution strategy for a firm. However, firms should make their own assessment as to the extent the proposals in this DP may apply to them.

1.13 Although this DP sets out initial proposals, the PRA expects that any final requirements would also relate to cases where the PRA is not the group consolidated supervisor but is instead the supervisor of a UK-incorporated subsidiary of an overseas group. In such cases, the PRA would liaise with the home supervisor and where relevant, may regard operational continuity requirements set by the home supervisor as being equivalent. For UK branches of a non-European Economic Area (EEA) entity the PRA will seek to understand how the home supervisor plans to deliver operational continuity and will take a more flexible approach to applying these requirements. The PRA would not impose any requirements on UK branches of EEA entities.

## Background to the proposals

1.14 The concept of operational continuity in this DP focuses on the arrangements that need to be made to ensure continuity of the critical shared services needed to facilitate a firm's recovery actions, resolution, or post-resolution restructuring. This is different from the concept of continuity of access which focuses on continuity from the customers' (in particular, depositors') point of view and is discussed in detail in CP20/14.

1.15 The FSB's 'Key attributes of effective resolution regimes for financial institutions'<sup>(1)</sup> recognised the importance of firms restructuring to ensure that there is operational continuity for their important economic functions. Key Attribute 10.5 states that *'to enable the continued operations of systemically important functions, authorities should evaluate whether to require that these functions be segregated in legally and operationally independent entities'*.

1.16 Subsequently, the FSB issued guidance<sup>(2)</sup> to help distinguish further between the functions that are important for the economy and the critical shared services which need to be continued to support them. Based on the FSB's guidance, this DP sets out below a similar distinction between critical economic functions and critical shared services.

- **Critical economic functions:** activities performed by regulated firms for third parties where the discontinuation of the economic function would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability. This may be due to the firm's size, market share, external and internal interconnectedness, complexity or cross-border activities.
- **Critical shared services:** services which support one or more of a group's material entities or business units in performing critical economic functions and where the sudden or disorderly failure of the shared services would lead to a serious disruption in the performance of these material business units or entities. Critical shared services can be performed by an internal unit, a separate legal entity within the group or an external provider. They may also cover services that are necessary to allow parts of the group to be separated from the rest of the group as part of a recovery action or in a post-resolution restructuring, for example as part of a divestment. Critical shared services only cover those services that are transactional and can be fully represented in contractual terms.

1.17 This DP focuses on critical shared services. The continuity of critical shared services is a necessary condition for the continuity of critical economic functions and one important element of the work to ensure that firms can be resolved in an orderly fashion.

## 2 Arrangements for critical shared services

2.1 The objective of ensuring the continuity of critical shared services can be achieved in a variety of ways. The PRA is proposing an outcome-based approach that builds on existing requirements and practices observed in the industry. The PRA views the following three structures as potentially effective:

- a dedicated intragroup service company providing critical shared services to one or more regulated entities;
- an operational division providing critical shared services from within a regulated entity with attributes that would allow resolution authorities to implement a separate service company model should they need to; and/or
- a combination of the above.<sup>(3)</sup>

2.2 Alternatively, critical shared services can be outsourced to third-party providers. While outsourcing is not the focus of this DP, such arrangements should satisfy similar requirements with respect to operational resilience as the structures listed above.<sup>(4)</sup>

2.3 The PRA's proposed framework has been structured around three design principles and eight assessment criteria.

(1) FSB (2011), 'Key attributes of effective resolution regimes for financial institutions', available at [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

(2) FSB (2013), 'Recovery and resolution planning for systemically important financial institutions: guidance on identification of critical functions and critical shared services', available at [www.financialstabilityboard.org/publications/r\\_130716a.pdf](http://www.financialstabilityboard.org/publications/r_130716a.pdf).

(3) These organisational structures are referred to in the DP as critical shared services providers.

(4) These arrangements are also addressed by outsourcing rules set out in the Senior Management Arrangements, Systems and Controls (SYSC) sourcebook in the PRA's handbook, available at <http://fshandbook.info/FS/html/PRA/SYSC>.



These design principles and assessment criteria take into account good practice observed across the financial services industry in the areas of outsourcing, off-shoring and restructuring. The PRA considers that the design principles would support recovery, resolution, and post-resolution restructuring of firms.

2.4 The design principles set out the necessary outcomes and the proposed assessment criteria would provide the assessment tool to determine whether or not firms comply. Firms would be expected to demonstrate how they meet the principles regardless of their exact organisational structure although some of the criteria may be more applicable to some organisational structures than others. This would be assessed on a case-by-case basis.

2.5 Firms are currently required to comply with existing PRA rules and expectations on General Organisational Requirements (SYSC 4) and Outsourcing (SYSC 8). Moreover, firms have to apply relevant SYSC rules not only to arrangements with third parties but also to relevant intragroup arrangements. The preliminary proposals in this DP would not replace any of these existing rules or PRA expectations.

## Design principles

2.6 **Design Principle 1: restructuring capabilities** — the organisation and structuring of critical shared services shall facilitate the operational execution of a firm's recovery and resolution plan. This may include supporting identified divestment opportunities and minimising the necessary timelines for implementing these divestment options.

2.7 **Design Principle 2: contractual service provisions** — the firm should document the services provided to it (intragroup and from third parties) and have clear parameters against which it will assess whether the contractual provision of these services meets the operational continuity objectives. This documentation of contractual provisions should help facilitate the transferability of these service relationships if required. Contractual agreements between legal entities (including with third parties) should not contain clauses that allow the service provider to alter the provision of services to a firm solely as a result of it entering into a period of stress, failing, or entering resolution.

2.8 **Design Principle 3: financial and operational resilience** — operational capabilities of critical shared services should not be unduly affected by the failure or resolution of any material group entities or a stress event involving group members. In particular, critical shared services should have sufficient funding and operational capabilities to ensure that they can continue to operate and are capable of being restructured despite the failure or resolution of any group entities being serviced.

## Assessment criteria

2.9 **Assessment Criterion 1: ownership structure** — the critical shared services should be structured so that upon the failure or resolution of any entity in the group no serviced entity or business unit is made worse off due to the preferential treatment of other serviced entities or business units. This is to ensure that in the event of a group entity failing and being resolved there is a reduced possibility of other group entities either disrupting service provision to the entity being resolved or having their service provision disrupted. This could occur if pressure is put on the service provider to prioritise its resources to support some group entities over others.

2.10 **Assessment Criterion 2: objective service agreements** — the critical shared services should be clearly and precisely identified and the provision of these services should be formalised through granular service level agreements (SLAs). The PRA considers that contractual arrangements between different legal entities should, to the extent possible, remain valid and enforceable in all relevant jurisdictions regardless of the entry into resolution of one of these entities. If critical shared services are provided from within the same legal entity as the serviced business unit then services should be documented in internal SLAs that can form the basis of legally-binding SLAs in case the service provision is transferred to another legal entity. Objective SLAs facilitate identifying operational interdependencies and may guide any restructuring efforts. Following resolution they can support restructuring of a group.

2.11 **Assessment Criterion 3: charging structure** — charges for services should be set on an arm's length basis. If critical shared services are located in a separate legal entity arm's length terms can help to ensure that the shared service provider is not reliant on discretionary capital injections by other entities in the group. If the services are located within a regulated entity similar internal charging structures are necessary to ensure that the corresponding documentation could form the basis of an external contract if the critical shared services provider is restructured following resolution.

2.12 **Assessment Criterion 4: scale and scope** — critical shared services only cover those services that are transactional and can be fully represented in contractual terms. Functions that fail to meet this criteria and that require strategic judgements (in particular risk management and client facing roles), or that may result in financial exposures, should not be transferred to an intragroup critical shared services provider. Including these activities in a service provider may make the service provider unnecessarily large and complex. This may make it harder to restructure the service provider if necessary and ensure continuity of critical shared services.

**2.13 Assessment Criterion 5: governance structure** — the critical shared services should have their own governance structure. While the PRA does not consider that it is necessary to restrict reporting lines to other parts of the group, such reporting lines should be clearly defined. The critical shared services should have sufficient governance oversight in place to ensure that in a resolution event critical services can be provided without relying on senior staff from business lines that may be wound down or that may no longer form part of the same group.

**2.14 Assessment Criterion 6: ownership or continued access to operational assets** — access to operational assets by the critical shared services provider as well as by the serviced entities, business units, or the authorities should not be disrupted by failure or resolution of any group entities (including the critical shared services provider itself). In some cases, this may require that operational assets essential to performing critical shared services are owned or leased by the same legal entity that performs these critical shared services. However, this should not restrict serviced entities from using shared assets directly where appropriate. This criterion is necessary to ensure that conflicts of interest and litigation disputes around operational assets are minimised.

**2.15 Assessment Criterion 7: operational resilience** — critical shared services should have sufficient staff and other resources to facilitate the necessary restructuring of services and functions within the critical shared services provider in the event of the failure of any entity in the group. This may also include credible operational contingency arrangements that can ensure self-sufficiency. Operational resilience should not be unduly affected by failure or resolution of any group entities.<sup>(1)</sup>

**2.16 Assessment Criterion 8: financial resilience** — the provider of critical shared services should have sufficient financial resources, both capital (or otherwise loss-absorbing resources) and liquidity, available for the continuation of those services following the failure or resolution of any group entities. The PRA's view is that the firm should have available, as a minimum, capital resources equivalent to 25% of annual fixed overheads<sup>(2)</sup> and liquidity resources equivalent to 50% of the annual fixed overheads. These financial resources may be necessary to manage the risks that intragroup service providers are exposed to in a failure or resolution event within the group as set out in the table below. Additional resources may be needed depending on the exact composition of risks that the service provider may be exposed to.

Risk	Capital	Liquidity
1 Temporary loss of revenue due to suspension of payments from clients during the resolution period.	✗	✓
2 Expense-revenue mismatch during resolution, related to reduced demand for services from entities in resolution but constant fixed overheads for the service provider.	✓	✓
3 Employee costs, for example retention and redundancy payments.	✓	✓
4 Restructuring and wind-down costs.	✓	✓
5 Write down of intangible and relationship-specific assets.	✓	✗

**2.17** The methods through which the PRA may seek to ensure that firms meet its expectations with respect to financial resilience would vary depending on whether the critical shared services provider was a PRA-regulated entity or not.

- Where shared services are in an intragroup service company not regulated by the PRA, the PRA may require the PRA regulated service recipient to ensure that its service provider has appropriate financial resources which are ring-fenced from other group entities.
- Where shared services are located in a PRA-regulated entity itself, the PRA may increase capital and liquid asset requirements on that entity. Although it may not be possible to prevent these resources from being eroded due to the firm's risk-taking functions, imposing these additional requirements helps improve the firm's resilience. Further consideration would need to be given to how this would interact with the prudential regime and existing requirements.

**2.18** Further consideration will also need to be given to how to ensure that liquid assets of critical shared services providers are available to the service providers regardless of the failure or resolution of other group entities. For dedicated service providers in a separate legal entity this may require the service provider to hold liquid assets and/or cash outside the group with third parties. For PRA-regulated service providers it may be necessary to consider similar restrictions on holding liquid assets with other regulated entities in the group.

(1) Note that this definition of operational resilience focuses on resilience of critical shared services in a resolution scenario. It may differ from the way in which the term is used in other contexts.

(2) It is proposed that firms would calculate their fixed overheads, using figures resulting from the applicable accounting framework, by subtracting the following items from the total expenses after distribution of profits in their most recent audited annual financial statements:

- fully discretionary staff bonuses;
- employees', directors' and partners' shares in profits, to the extent that they are fully discretionary;
- other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary;
- shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue, and where the payment of the commission and fees payable is contingent upon the actual receipt of the commission and fees receivable;
- fees, brokerage and other charges paid to clearing houses, exchanges and intermediate brokers for the purposes of executing, registering or clearing transactions;
- fees to tied agents in the sense of point 25 of Article 4 of Directive 2004/39/EC of the European Parliament and of the Council;
- interest paid to customers; and
- non-recurring expenses from non-ordinary activities.

Consideration would need to be given to how this would interact with the prudential regime and existing requirements.

2.19 The PRA is open to exploring options of what should constitute liquid assets for dedicated intragroup service companies. This could potentially include a broader range of assets than the set of assets that would qualify to meet the Liquidity Coverage Ratio<sup>(1)</sup> for regulated firms. It may also be possible for the service provider to arrange lines of credit that are external to the group and that may be secured by assets used exclusively by the service provider as an additional liquidity resource.

### 3 Questions

3.1 The PRA is interested in views on all aspects of this paper, including the scope of the proposal, the design principles and the proposed assessment criteria. Questions that the PRA is particularly interested in are listed below. Responses should be submitted by Tuesday 6 January 2015.

**Question 1:** Should the scope of the proposals to ensure operational continuity cover PRA-regulated banks, building societies and investment firms?

**Question 2:** Are there specific elements of SLAs that should be required in order to meet the objective of operational continuity?

**Question 3:** Should firms be mandated to have a central repository for all SLAs?

**Question 4:** Are there any specific activities or services that should be prohibited from being part of the shared service provider?

**Question 5:** What governance and ownership structures would ensure the operational independence of a shared service provider?

**Question 6:** What type of managerial skills or other assets would a shared service provider need to restructure its operations upon the failure or entry into resolution of significant group entities or business units?

**Question 7:** Are the financial resilience proposals sufficient to cover losses and a liquidity stress that could be generated by a failure or resolution event within the group?

**Question 8:** How can it be ensured that the liquid assets of the shared service provider will be available in the event of a failure or resolution of other entities in the group?

### 4 Cost-benefit analysis

4.1 The purpose of this DP is to describe some of the PRA's preliminary views on operational continuity arrangements. Given that many details of the proposal are yet to be determined it is not possible to provide a clear assessment of the costs and benefits, or other statutory obligations that the PRA considers when making policy.

4.2 From a qualitative perspective, the PRA considers that firms may have insufficient incentives to ensure that they are resolvable. There are a number of potential market failures that explain why banks may lack sufficient incentives to invest in their resolvability. One potential market failure is that firms may not take into account the spillovers that their disorderly failure can impose on others. Moreover, financial counterparties may not ask for appropriate compensation for the risks that such spillovers can impose on them, for example due to informational asymmetries counterparties may be unable to assess whether the failure of the firm would expose them to significant risks or not. The discontinuity of critical economic functions may also have an impact on the wider economy.

4.3 The proposals should help address these market failures and should contribute to financial stability by ensuring that firms can more easily be restructured post-resolution without imposing substantial externalities on the rest of the financial system. If firms can be resolved in an orderly manner this should reduce implicit taxpayer subsidies, which should reduce incentives for excessive risk-taking.

4.4 The cost of meeting the assessment criteria proposed in this DP are two-fold: the implementation cost, largely relating to Assessment Criteria AC1 to AC7, and the ongoing costs associated with the financial resilience proposal (AC8). Given that the PRA will apply any eventual proposals on a proportionate basis, the PRA expects that the costs for smaller firms will be considerably lower than the costs that may be incurred by the largest banking groups who would have to undertake more restructuring to improve their resolvability. The PRA welcomes estimates on the costs that any firms within the scope of the proposal expect to incur in order to meet the proposed assessment criteria.

4.5 Banks that seek to fulfil the criteria predominantly through intragroup service companies may initially face higher implementation costs, resulting from the need to transfer assets and services into a different legal entity. Conversely, firms that seek to fulfil the criteria predominantly by keeping critical shared services within the regulated entity may initially have lower implementation costs. However, the PRA

(1) The European Commission is to adopt a delegated act to specify the liquidity coverage requirement set out in Regulation (EU) No. 575/2013.

recognises that both the relative implementation costs of these structures as well as the ongoing costs will depend on firm-specific characteristics. Hence, allowing firms to meet the criteria through their preferred structure will help reduce the costs of doing so.